First State Investments
首域投資

# Asian Quality Bond

## Monthly Review and Outlook

May 2016

- First State Asian Quality Bond Fund invests in debt securities of issuers organised, headquartered or having their primary business operations in Asia.
- The Fund invests in emerging markets which may involve a greater risk than developed markets including sharp price movements, liquidity risk and currency risk. The Fund may invest in below investment grade and unrated debt securities. This exposes the Fund to greater liquidity risk, default risk and price changes due to change in the issuer's creditworthiness. The Fund invests in fixed income securities which may be impacted by movement in interest rates. It is possible that the entire value of your investment could be lost.
- For the monthly distributing Shares Class, any fees and expenses relating to this Share Class may be paid out of capital resulting in an increase in distributable income. At times the dividend may be paid out of capital. This amounts to a partial return of an investor's original investment, or from any capital gains attributable to that original investment, and may result in an immediate decrease of the Net Asset Value per share.
- You should not base your investment decision solely on this document. You should not invest unless the intermediary who sells it to you has advised you that the Fund is suitable for you and explained how it is consistent with your investment objectives.

## Key highlights:

- Despite a more hawkish US Fed, softer China data and a looming Brexit vote, Asian credit market managed to eke out a 5th consecutive month of positive return.
- The People's Bank of China left monetary policy unchanged with no rate cuts or easing in the reserve requirement ratio.
- The Federal Open Market Committee (FOMC) chair Janet Yellen herself took a less dovish tone when speaking at the end of the month, noting that a rate hike in "coming months" would be appropriate if the economy continues to strengthen.
- We continue to keep a close eye on various reforms being rolled out especially those targeting an improvement in productivity as this is crucial in eventually driving growth in the longer term.
- Asian credits are looking fair at this juncture factoring the numerous headline risks we could be facing in the months ahead.

## Market commentary

Despite a more hawkish US Fed, softer China data and a looming Brexit vote, Asian credit market managed to eke out a 5th consecutive month of positive return. We witnessed a pick-up in new issuance during the month, providing a much needed boost to the liquidity condition in the lackluster secondary market. Spread of the JPMorgan Asia Credit Index (JACI) tightened by 7bps to 266bps, more than offsetting modestly higher US treasuries yield. This 0.32% monthly gain brought year to date return of the JACI to a remarkable 4.68%. High yield outperformed investment grade during the month with returns of 0.94% and 0.17% respectively. By countries, spread returns were largely positive with the exception of Malaysia and Sri Lanka.

With June imminently a month big on news flow (central bank meetings, European elections, British referendum, OPEC meeting, ECB corporate bond buying), May potentially could turned out to be the calm before the storm. In terms of monetary policy, most major central banks did not meet in the month while The People's Bank of China left monetary policy unchanged with no rate cuts or easing in the reserve requirement ratio. Nevertheless, China continues with its capital account liberalization strategy. The People's Bank of China (PBoC) and State Administrative of Foreign Exchange (SAFE) simultaneously released a document each to clarify and simplify the regulations governing foreign investments in its bond market via the China interbank bond market (CIBM) program. This is yet again a strong testament to China's desire to be included in major global bond indices which would lead to significant inflows into the China government bond (CGB) market.

There was no FOMC meeting in May. Instead, focus was placed on the release of the April meeting minutes and rhetoric from voting members throughout the month. The general consensus amongst the Fed speak during the month was for a rate hike in June/July. Chair Janet Yellen herself took a less dovish tone when speaking at the end of the month, noting that a rate hike in "coming months" would be appropriate if the economy continues to strengthen. As a result of the more hawkish tone, the market is now pricing in a 50% chance of a rate hike by July, compared to only 25% probability at the start of the month.

New USD issuance continued its strong momentum from April amounting to USD 17.5b. Despite this compelling number, year to date issuance still lagged that of the same period in 2015 by 23%. Chinese issuance dominated supply accounting for 81% followed by a distant 13% from South Korea.

## Performance

In USD term, the First State Asian Quality Bond Fund returned 0.19% in May[1].

[1] The Fund's calendar year performance: 0.9% (2015); 6.8% (2014); -3.0% (2013); 9.1% (2012); 2.5% (2011).

# Portfolio positioning

We reduced our short duration in the US following a bear flattening of the curve led by the short end. We increased modestly our local currency exposure in Indian government bonds amid a weakening in the rupee as India remains an attractive long term carry play. During the month, we also participated in new issues from Huarong and Three Gorges.

By country, we remained overweight in China and also Hong Kong partly offset by a short in Philippines. We continue to overweight in high quality Chinese names including China Overseas Land, Sinochem, Citic Pacific and Alibaba while underweighting the oil and gas sector which includes names like CNOOC, CNPC and SINOPEC due to potential supply and low profits in these companies amid falling oil price in the past year. We also like Hong Kong corporates as these firms have strong track records in riding through down cycles.

# Investment outlook

As we progress well into 2016, we see very little reasons for us to change the cautious stance that we have on global growth since the beginning of the year. While we see a continuation in the improvement of the US economy, growth will remain unspectacular. Europe will likely grow at 1-1.5% underpin by recent improvement in private consumption while Japan needs more structural changes before we get optimistic again with Abenomics. Over in Asia, we expect export figures to remain soft at best though investors are starting to get a better grasp on China's reform efforts and economic rebalancing. Despite fundamentals remaining largely unchanged, we witnessed a strong rally in risky assets during the February to March period on the back of a recovery in oil price and dovish rhetoric from major central banks. While the technical backdrop is still positive, this exuberance is unlikely to continue if economic fundamentals do not improve from here and thus we would advocate taking on a defensive strategy in portfolio positioning. Key risks factors in the near term would include Brexit, reversal of the strong rally in oil and commodity prices and inflation in the US rising quicker than expected forcing the US Fed to raise rates faster than what they have been communicating.

Following the first rate hike in December 2015, the US economy made decent progress supported by a continued improvement in the labour market which is moving close to full employment. Business investment spending showed marked improvement during the first quarter while consumer spending exhibited moderate growth. Exports however have remained weak amidst slower global growth and a strong US dollar. Against this backdrop and a still benign inflationary outlook, the US Fed lowered their rate hikes projections from four to two for 2016. While we concur with the market that a weak global outlook and negative yields all around Europe and Japan will cap policy divergence between the Fed and other major central banks, a sustained rise in inflation if materialize, will lead the Fed to change tack and normalize rates quicker than what market is currently expecting. This is not our base case scenario but a risk that investors should be cognizant of.

Eurozone continued to show the resilience that helped it achieved the 1.5% growth we witnessed in 2015. While the region is not immune to the slowdown in global trades as evident in its subdued export numbers, domestic demand remained strong on the back of easy monetary policy, low oil and commodity prices and improving labour markets. Recent manufacturing PMIs have also recovered from the lows, suggesting some signs of stabilization. Services sector indicators have softened recently but stayed at elevated levels, reflecting the robustness of domestic demand while higher public spending resulting from a lenient European Commission has helped underpinned growth. Though we are impressed with recent data, we are not overly excited about Europe as a growth at around 1.5% will not be enough to close the output gap. Furthermore, the easy fiscal conditions that have be supportive towards growth may not persist while the effectiveness of ultra-easy monetary policy may also have started waning. Brexit in June remains a possibility and if materialize will cause great disruption to economic development in Europe.

Over in Japan, the optimistic growth outlook at the start of the year has all but diminished. Private consumption remained very soft while the latest BOJ's tankan survey for business conditions came in worse than expected. The stagnant household consumption is a huge disappointment especially when household expenditure got a boost from a broad based wage growth which is expected to continue for the 3rd consecutive year. Fiscal policy while credible seem to have little impact on consumption too. The government recently announced that it will provide subsidy for 12.5 million low income household as part of the JPY 3.5 trillion budget. Further downside risks in Japan's economic growth are real and that include a sharp deterioration in growth amongst Japan's major trading partners and a continued appreciation in the Yen which will hurt Japanese exports.

The ongoing economic reform and rebalancing in China has led to slower growth in China though we sense as the reforms continue, investors will have a better appreciation of how these reforms will eventually benefit the country. Volatility in the renminbi has also dropped as concerns over outflows from China alleviate. Manufacturing PMIs while soft, is consistent with downside surprises on the export front and this is to a large extent offset by a rising domestic consumption. Fiscal stimulus while targeted will remain supportive towards growth following the pledge at the annual National People's Congress to raise fiscal deficit target from 2.3% of GDP last year to 3% in 2016. On monetary policy, we expect at least 2 more rate cuts and further banks' reserve ratio cut up to another 300 bps for the rest of the year as China strive to maintain its growth target of 6.5%-7%. The renminbi is also expected to weaken gradually once the Fed resume normalizing policy rate though the People's Bank of China will likely steer the currency to move more in line with other trading partners' currencies instead of the consensus view that they will use its weakness to spur exports.

As China slows, Asian economies will likely remain stuck in a protracted period of anemic growth. This is because for many Asian economies, China is the biggest trading partner and a major buyer of raw materials and industrial components. Asian exports could also be facing continued weakness due to what could be a structural trend of developed economies starting to produce what they used to import, as cost of production falls. Against this backdrop, we expect countries that are more dependent on exports including Singapore, Malaysia, South Korea and Taiwan to continue experiencing weak growth. Indonesia and Philippines are likely to hold up better due to their stronger domestic demand. Monetary policies across Asia should remain accommodative as most Asian central banks still have room to cut policy rates should growth continue to surprise on the downside. Nonetheless, with the Fed having started a hiking cycle, we do expect them to tread more cautiously as a divergence in monetary policy from the US could lead to sudden outflows which is very destabilizing for the economy. Indonesia, Malaysia and Sri Lanka are likely to be the most vulnerable in such a scenario.

We continue to keep a close eye on various reforms being rolled out especially those targeting an improvement in productivity as this is crucial in eventually driving growth in the longer term. Despite being entrenched in slower growth and facing an uncertain outlook, we do not see the current situation culminating into an Asian economic crisis. Asian's local currency bonds market's development over the past

decade has led to reduced reliance on USD funding. FX regime is now more flexible in Asia unlike in the 1990s when many of them have some form of a peg to the USD. On top of a higher FX reserves, many central banks now have multi-lateral and bilateral currency swaps agreements which serve as a useful liquidity tool in times of stress.

We believe valuation in Asian credits are looking fair at this juncture factoring the numerous headline risks we could be facing in the months ahead. Credit metrics are still weakening albeit at a slower pace while technical backdrop for Asian bonds is positive with yields having turned negative in many developed markets. We have also turned from positive to neutral on Asian currencies following the stellar year to date performance. Despite our cautious stance, we see any sell-off as opportunities to re-establish long positions in both credit and local currency bonds as we remain positive on Asia's longer term fundamentals and its ability to ride through this period of uncertainty.

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